IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No.

THE HIRSCH IMPROVEMENT COMPANY,

Petitioner,

—*v.*—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR CERTIORARI

Jurisdiction.

The statement of jurisdiction is set forth in the foregoing petition.

Statement of the Case.

The facts have been set forth in the foregoing petition.

SUMMARY OF ARGUMENT

POINT I.

The Court erred in determining that the $35,000.00 security deposit should be included in income.

POINT II.

The Court erred in determining that the petitioner was doing business in the year ended June 30, 1936.

POINT III.

The Court erred in failing to determine that the petitioner was entitled to a refund of excess-profits tax paid for year 1936 in the amount of $5,369.23, plus interest thereon.

POINT I.

The Court erred in determining that the $35,000.00 security deposit should be included in income.

We have been unable to find a case in this Court which bears directly upon the question of what constitutes a security deposit and when such deposit is to be included in gross income.

The Tax Court found that the $35,000.00 was deposited with the petitioner "*as security for the rent and performance of the conditions of the lease* * * *;" (R. 186). (Italics ours.)

In its opinion, the Tax Court stated:

> "In the case at bar the fund was to serve a *dual purpose* as *security* and as rent. * * * " (R. 196). (Italics ours.)

Under the rule announced by this Court in the case of *Dobson* v. *Commissioner*, 320 U. S. 489, the Tax Court's finding that the $35,000.00 was security must be given controlling weight in arriving at a conclusion as to its taxability. The determination by the lower courts that the fund was taxable in the year of receipt was inconsistent with the finding that it was security, and constituted an erroneous application of the legal principles governing the taxability of the fund as announced by the Circuit Court of Appeals, Fifth Circuit, in the case of *Clinton Hotel Realty Corporation* v. *Commissioner*, 128 F. (2d) 968.

The similarity of the facts in this case to those in the *Clinton Hotel* case, *supra* clearly demonstrate the conflict created by the Circuit Court's decision in the instant case. *Neither the Tax Court nor the Circuit Court has advanced any clear distinction between the instant case and the Clinton decision.* In fact, the Circuit Court recognized the existing conflict, saying:

> "Expressions in Clinton Realty Corp. v. Commissioner, 128 F. (2d) 968 (C. C. A. 5) *so far as they may appear to be inconsistent with our decision,* were qualified by a subsequent case in the same Circuit, Astor Holding Co. v. Commissioner, 135 F. (2d) 47 (C. C. A. 5) * * *." (Italics ours.)

The distinction between the *Astor Holding Co.* case and the instant case is indicated by the following language in the Circuit Court's decision:

> "The payment involved in the Clinton Hotel Case was 'always referred to as a "security" or as a "deposit", and it was obvious that there were many things to which it might become applicable besides the tenth year's rent'. * * *."

A further distinction between the two cases is found in the Tax Court's memorandum opinion, stating:

> "At no place in the lease is the payment in question designated other than by such terms as 'rent' or 'moneys' theretofore paid on account of this lease! Nowhere does the lease designate this sum or any part of it as 'security' for any purpose."

It is strongly urged that the principle of the *Clinton Hotel* case, *supra* is applicable to the facts herein. The

legal rules governing the question at issue were stated by the court as follows:

> "It is not denied that if the $21,000 was paid and received as rent in advance, it was taxable, though not yet earned. *United States* v. *Boston & Providence R. R. Corp.*, 37 F. (2d) 670; *Renwick* v. *United States*, 87 F. (2d) 123; *Commissioner* v. *Lyon*, 97 F. (2d) 70. On the other hand, if it was paid and received as security, with no present right or claim of full ownership, it would not be presently income, although it was expected finally to be applied in payment of the last year's rent if nothing happened to prevent. *Barker Estate*, 13 B. T. A. 562; *Warren Service Co.* v. *Commissioner*, 110 F. (2d) 723. *In the latter situation, though the money is rightfully received, and if the parties so intend may be freely used, yet because of the acknowledged liability to account for it, there is no gain; just as in borrowing there is none.* The case of *North American Oil Consolidated* v. *Burnet*, 286 U. S. 417, 424 has no application, for the recipient of the money there claimed it was fully his, he acknowledged no right in another, and the holding was that a contrary claim by that other which might prove good would not prevent the receipt of the money being present income." (Italics ours.)

The rule announced by this Court, that taxable income results from money received under a claim of right and without restriction as to its use, does not apply to the instant case. The facts clearly show that the $35,000.00 security, as contrasted with the $25,000.00 advance payment, was paid and received as security with no present right or claim of *full* ownership.

In the instant case, the lower courts have based their decisions in part upon the erroneous determination that the application of the fund to purposes other than rent was a condition subsequent to its serving as rent. The contrary is strongly urged by your petitioner. The application of the fund as rent was a definite condition subsequent which could only become effective *after* it had served as security. Consistently and logically the fund must be security first, and *subsequently only*, may possibly be applied as rent.

The petitioner was liable to account for the fund to its sublessee until the last year of the rental term. Only then, —after giving its sublessee possession of the demised premises,—could the petitioner have the unrestricted *full* ownership of the security fund. The money was not includible in the petitioner's gross income until its character as rent became definitely ascertainable. (*Virginia Iron, Coal & Coke Co.* v. *Commissioner*, 99 F. (2d) 919 (C. C. A. 4), cert. den. 307 U. S. 630.)

In *Virginia Iron, Coal & Coke Co.* v. *Commissioner*, 99 F. (2d) 919 (C. C. A. 4) cert. den. 307 U. S. 630, the recognized rule applicable to the instant case was stated as follows:

> "That, when it became possible to determine the character of the payments and to definitely ascertain that they were income to the taxpayer as payments for an option, they should be taxed, is not to be disputed."

The continuing right of the lessee of the premises in the $35,000.00 security prevents the Commissioner from burdening the fund with a tax obligation or liability. In the event the lessee should become bankrupt or make an assignment for the benefit of creditors, the petitioner could not retain the security. (*Cain* v. *Brown, Assignee*, 105 Ohio St. 264,

136 N. E. 916; *Floro Realty & Investment Co.* v. *Steem Electric Corporation, et al.,* 128 F. [2d] 338; *Remington on Bankruptcy,* Vol. 3, Sec. 1211.01; 8 *C. J. S.,* 173; *Jensen* v. *Sparks,* 53 F. [2d] 433.)

Actually, the $35,000.00 was a pledge which created the relationship of debtor and creditor, and the recognized rule that no income results from borrowing was erroneously disregarded.

In Vol. 36 Corpus Juris, page 296, Landlord & Tenant, section 1063, it is said:

> "Money deposited by a tenant with the landlord as security for the payment of rent or the performance of other covenants constitutes a *pledge,* * * *."

See also:

> *Mendelson-Silverman, Inc.* v. *Malco Trading Corp.,* 146 Misc. 215 (affd. 262 N. Y. 621);
> *Shattuck* v. *Buek,* 158 App. Div. 709 (N. Y.);
> *Matter of Atlas,* 217 App. Div. 38 (N. Y.);
> *Cain* v. *Brown,* 136 N. E. 916, 105 Ohio St. 264.

In *Matter of Atlas,* 217 App. Div. 38 (N. Y.), a tenant had deposited the sum of $5,000.00 with the landlord to be held by the landlord "as security for the performance of this lease and every condition thereof and shall apply to the last month's rent of the term herein, on conditions hereinafter set forth. * * *."

In construing the nature of this deposit, the Court said (p. 41):

> "The first question that arises relates to the character of the $5,000.00 payment. Did it become the property of the lessors upon payment, or did it continue the

> property of the lessee? * * * but one conclusion in our opinion can fairly be drawn from the evidence, namely, that the sum was paid to the lessors *as a fund continuing to belong to the lessee,* but entrusted to the lessors to hold as security against defaults of the lessee in accordance with the terms of the lease, and finally, if not previously required to make good defaults of the lessee, to be applied in payment of the rent for the last months of the term. * * *."

In the light of the State Court decisions that similar deposits represent security and create a debtor-creditor relationship, the lower courts should have determined that no taxable income resulted to your petitioner from the receipt of the $35,000.00 by the petitioner in year 1936.

The impropriety of the Tax Court's determination in respect of said security is further demonstrated by reference to the provisions of sections 41 and 42 of the Revenue Act of 1936 and Regulations thereunder. These statutes and regulations are hereinabove set forth (see p. 3), and provide, in effect, that each year's income must be accounted for in a manner which clearly reflects the taxpayer's annual income.

The inclusion of the $35,000.00 security in petitioner's taxable income for year 1936 would not clearly reflect the petitioner's actual net income for either year 1936 nor year 1955, the last year of the term of the McCrory sublease.

The petitioner is required in each year to pay to the owner of the property annual rent of $27,500.00 under its own lease of the premises. The petitioner also pays other deductible expenses in each year. (See Petitioner's 1936 Income Tax Return, R. 216, also Exhibit "N" attached to Stipulation of Facts, R. 166-168.)

Out of each year's annual rental income received by the petitioner, it must pay, and should be permitted to deduct

its own rent and expenses in order to clearly reflect its true annual net taxable income.

If the $35,000.00 security, which it is submitted was not income at all to the petitioner, were required to be included in its 1936 taxable income, the petitioner's income would be highly exaggerated and not in accordance with the actual facts. The deductions which will become applicable to the property in year 1955, and which properly should be offset against rental income for year 1955, are not allowable to the petitioner in year 1936. A converse situation would occur in year 1955.

It is respectfully urged that Congress never intended to create such a situation in respect of *any* taxpayer. The Commissioner's regulations clearly show that the determination against this taxpayer is contrary to the Commissioner's own interpretation under the Acts of Congress.

In *Knowlton* v. *Moore,* 178 U. S. 41, 77, this Court said:

> "* * * where a particular construction of a statute will occasion great inconvenience or produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute."

The inequality and injustice which would result in this case should be avoided.

In *Gould* v. *Gould,* 245 U. S. 151, 153, this Court said:

> "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. *In case of doubt they are construed most strongly against the government, and in favor of the citizen. United States* v. *Wig-*

glesworth, 2 Story, 369; *American Net & Twine Co.* v. *Worthington,* 141 U. S. 468, 474; *Benziger* v. *United States,* 192 U. S. 38, 55." (Italics ours.)

In the instant case the lower courts have extended the Congressional definition of "gross income" to include that which was not income and might never become income to the petitioner.

POINT II.

The Court erred in determining that the petitioner was doing business in the year ended June 30, 1936.

This Court has recently recognized the existing conflict and confusion in the cases involving the question of what constitutes carrying on or doing business. Speaking for the Court in *Magruder* v. *Washington, Baltimore and Annapolis Realty Corp.* (307 U. S. 69), Mr. Justice Murphy said:

> " * * * The crucial words of the statute, 'carrying on or doing business', are not so easy of application to varying facts that they leave no room for administrative interpretation or elucidation. To be sure, in many * * * instances, the factual situation will be so extreme as to leave no doubt whether a corporation is doing business or not. *But the nuances of facts between the two extremes have produced a nebulous field of confusion* * * *." (Italics supplied.)

The petitioner's activities in year 1936 consisted of subleasing its premises, distributing the avails of its property, and making disbursements to cover expenses incurred in connection with litigation with one of its lessees. It paid no salaries either to its officers or its directors.

Mr. Justice Holmes, speaking for this Court in *United States* v. *Emery, Bird, Thayer Realty Company* (237 U. S. 28), concluded:

> "The claimants' characteristic charter function, and the only one that it was carrying on, was the bare *receipt and distribution to its stockholders of rent from a specified parcel of land.* Unless its bare existence as an intermediary was doing business, it is hard to imagine how it could be less engaged." (Italics ours.)

The decision of the Circuit Court of Appeals for the Second Circuit in the instant case not only is in conflict with the foregoing decision of this Court, but also is not in accord with the following cases decided by this Court and with decisions of various Circuit Courts in favor of taxpayers wherein this Court has denied certiorari or no certiorari proceedings have been instituted:

McCoach v. *Minehill & Schuylkill Haven R. Co.*, 228 U. S. 295;

Rose v. *Nunnally Inv. Co.*, 22 F. (2d) 102 (C. C. A. 5). Certiorari denied, 276 U. S. 628;

Goodyear Investment Corporation v. *Campbell*, 139 F. (2d) 188 (C. C. A. 6). (No certiorari proceedings instituted);

Argonaut Consolidated Mining Co. v. *Anderson*, 52 F. (2d) 55 (C. C. A. 2). Certiorari denied, 284 U. S. 682;

Sears, et al. v. *Hassett*, 111 F. (2d) 961 (C. C. A. 1). (No certiorari proceeding instituted);

North Pa. R. Co. v. *Rothensies*, 134 F. (2d) 333 (C. C. A. 3). (No certiorari proceedings instituted);

Continental Baking Corp. v. *Higgins,* 130 F. (2d) 164 (C. C. A. 2). (No certiorari proceedings instituted);

General Ribbon Mills, Inc. v. *Higgins,* 115 F. (2d) 472 (C. C. A. 2). (No certiorari proceedings instituted).

It is respectfully submitted that the facts herein clearly show that the petitioner was not carrying on business during the period from July 1, 1935 to June 30, 1936, and was not subject to excess-profits tax. Liability for such tax is conditioned upon liability for the capital stock tax,[1] which in turn requires for its imposition the carrying on or doing of business.[2]

During the year ended June 30, 1936, the petitioner was merely a lessor whose activities were restricted exclusively to the holding and *preservation* of its leasehold, and the receipt and distribution of its rental income. Its sole investment was its Cleveland leasehold.

The petitioner at no time sought new ventures or profits. It did not exchange any of its assets nor did it buy or sell anything (R. 234). Whatever activities it had were confined solely to the preservation of its leasehold investment.

The applicable opinions of this Court have been expounded somewhat exhaustively, yet tersely, by the Circuit Court of Appeals for the Sixth Circuit in the case of *Goodyear Investment Corporation* v. *Campbell,* 139 F. (2d) 188, decided on December 2, 1943. (No certiorari proceedings were instituted by the solicitor-general). There the Court said:

---

1. See section 106 of the Revenue Act of 1935 as amended by section 402 of the Revenue Act of 1936.

2. See section 105 of the Revenue Act of 1935 as amended by section 401 of the Revenue Act of 1936.

"It is doubtful that the Congress intended to exempt from the capital stock tax a pure holding company engaged in no activity but the ownership of securities and collecting and distributing dividends thereon, and to tax a pure holding company of improved real estate engaged in no activities but the collection of rents *and the safeguarding of its interests under the terms of the lease. There is no reasonable basis for such distinction and the controlling cases would seem to indicate that there is none. The corporation in McCoach* v. *Minehill Ry. Co., supra, held title to leased railroad property from which it collected rents,*—it was not carrying on *business.* In *U. S.* v. *Emery, Bird, Thayer Co., supra,* a corporation was organized to hold title to property and lease it to its parent company, receiving rents from the parent and distributing them to the stockholders, the lease providing that the lessor was to rebuild if the property should be destroyed,—the corporation was not doing business. * * *."

The petitioner had originally subleased its leasehold to but one tenant. The property was so occupied from 1924 until 1933, when the sole tenant went into bankruptcy (R. 233). The petitioner then stepped in to *protect its holdings* and negotiated for a short term lease (R. 233). In 1933, the petitioner was compelled to sublease a part of its leasehold to protect its investment (R. 233).

The petitioner did not operate the property and had no operating expenses. The execution of two leases (one on July 1, 1935 and the other in February, 1936), were but a continuation of the two existing tenancies, and were necessary for the preservation of petitioner's own leasehold, not for the purpose of seeking new or additional profits. Under these two subleases, the sublessees were required to operate the property.

The petitioner's prosecution of a claim against McCrory Stores Corporation, in bankruptcy, upon its previous default was not an activity for profit, but was merely an attempt to recover moneys owing to the petitioner. Its expenditures for legal services were chiefly in connection with the prosecution of said claim.

Can it be said that necessary activities thrust upon the petitioner in preservation of its investment constitute carrying on or doing business? In the light of this Court's decisions on the subject, we think not—no more so than the collection and reinvestment of proceeds of maturing securities, or the prosecution by a bondholder of a claim arising out of default by a corporation on its obligation. Clearly the bondholder who seeks to recover and protect his investment is not doing business. Nor did this petitioner do business when it acted to protect its leasehold investment.

In *McCoach* v. *Minehill & Schuylkill Haven Railroad*, 228 U. S. 295, this Court held that a railway corporation after it had leased its railroad to another company, which operated it, was not doing business, saying:

> "In our opinion, the mere receipt of income from the property leased (the property being used in business by the lessee, and not by the lessor) and the receipt of interest and dividends from invested funds, bank balances, and the like and the distribution thereof among the stockholders of the Minehill Company amount to no more than receiving the ordinary fruits that arise from the ownership of property."

It is strongly urged that this Court's foregoing decision is controlling in the instant case and that the decision of the Circuit Court of Appeals is inconsistent with principles announced by this Court.

POINT III.

The Court erred in failing to determine that the petitioner was entitled to a refund of excess-profits tax paid for year 1936 in the amount of $5,369.23, plus interest thereon.

If the petitioner is sustained upon the second issue herein, it follows that its claim for refund of excess-profits tax for year 1936 in the sum of $5,369.23, plus interest, should be allowed in full.

CONCLUSION.

It is respectfully prayed that this petition for certiorari be granted.

Respectfully submitted,

ELLIOT A. DAITZ,
Counsel for Petitioner.